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Nos. 87-453 and 87-464

In the Supreme Court of the United States

OCTOBER TERM, 1987

AMERADA HESS CORP., ET AL., APPELLANTS

v.

DIRECTOR, DIVISION OF TAXATION

TEXACO, INC. AND TENNECO OIL CO., APPELLANTS

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY

ON APPEALS FROM THE SUPREME COURT OF NEW JERSEY

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

Whether the Due Process, Commerce, and Equal Protection Clauses of the United States Constitution permit New Jersey, in defining the company-wide net income that is subject to apportionment for the State's corporate income tax, to disallow a deduction for crude oil windfall profit taxes paid to the United States.

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This brief is submitted in response to the Court's order inviting the Solicitor General to express the views of the United States.

STATEMENT

A. Since 1980, oil producers like appellants have been subject to the federal crude oil "windfall profit" tax imposed under Section 4986 of the Internal Revenue Code (I.R.C. or Code) (26 U.S.C.). The tax was created by the Crude Oil Windfall Profit Tax Act of 1980, I.R.C. §§ 4986-4998, in conjunction with the removal of federal ceilings on oil prices. The federally controlled price of domestic oil at the time ranged from \$5.86 to \$13.06 per barrel, while the world market price had risen to

nearly $20 per barrel. When President Carter decided to decontrol prices, he and the Congress also determined that the resulting "windfall" to oil producers should be subject to a special "windfall profits" tax. H.R. Rep. 96-304, 96th Cong., 1st Sess. 4-7 (1979); S. Rep. 96-394, 96th Cong., 1st Sess. 6-8 (1979); Windfall Profits Tax and Energy Security Trust Fund, 15 Weekly Comp. Pres. Doc. 721-727 (Apr. 26, 1979); *United States* v. *Ptasynski*, 462 U.S. 74, 76 (1983). Rather than levy a special tax on increased company-wide net income, however, the President and Congress chose to impose an "excise tax" on the increase in value of each barrel of crude oil at the wellhead (I.R.C. § 4986; 15 Weekly Comp. Pres. Doc. at 723), evidently intending by that method to simplify the enforcement of the tax and to minimize the possibility of noncompliance (see H.R. Rep. 96-304, *supra*, at 43; S. Rep. 96-394, *supra*, at 66-67).

The event that triggers imposition of the tax is removal of oil from the oil-producing premises, which may occur by sale of the oil, by its on-site refining, or by its transportation away for use in another part of the producer's business. I.R.C. §§ 4986(a), 4988(c). The figure to which the tax is applied, or the measure of the tax (the "windfall profit"), is generally the increase in value of the oil at the wellhead due to decontrol—the difference between (i) the "removal price," which is the actual or constructive sale price at the premises after decontrol (I.R.C. § 4988(c)), and (ii) the "adjusted base price" plus the state "severance tax adjustment," which is the approximate price of the oil prior to decontrol, adjusted for inflation, plus the increase in state severance taxes caused by the higher prices resulting from decontrol (I.R.C. §§ 4989, 4996(c)). I.R.C. § 4988(a).[1] To avoid burdening high-cost production (H.R. Rep. 96-304, *supra*, at 2; S. Rep. 96-394, *supra*, at 29), however, the measure of the tax on each barrel may not exceed 90% of the "net income" from the barrel, which is determined property by property and which, when there is no on-site sale, is based on the market price at the property at the time of removal. I.R.C. § 4988(b); 26 C.F.R.

[1] The Act assigns different base prices to different types (or "tiers") of oil. See I.R.C. §§ 4989(c) and (d), 4991.

1.613-3(a). (Accordingly, it is possible for an oil producer to incur substantial windfall profit tax liability even though its company-wide net income, calculated even without subtracting the windfall profit tax, is zero or negative.)[2] The rate of the tax for the years at issue in these cases, 1980 and 1981, varied from 30 to 70%, depending on the type of oil being produced. I.R.C. § 4987.[3]

In addition to the windfall profit tax, oil-producing corporations like appellants are subject to the federal corporate income tax under Section 11 of the Code. "Since the windfall profits tax is an excise tax, it is deductible for income tax purposes." 15 Weekly Comp. Pres. Doc. at 723. Although the tax paid to the United States on removal of oil from the production premises would generally be deductible as a business expense under Section 162 or 212 of the Code even without separate statutory authorization (see H.R. Rep. 96-304, *supra*, at 14 ("[t]he windfall profit tax is a deductible business expense under the income tax"); 26 C.F.R. 1.164-3(f)), Congress explicitly provided in Section 164(a)(5) for the deductibility of that amount even where it is not a business expense. "Such a deduction is consistent with the usual treatment of excise taxes and prevents

[2] Assume, for example, that a company consisted entirely of two producing properties, A and B; that A produced a profit of 100, of which 40 was windfall profit; that B produced a loss of 100; and that the applicable windfall profit tax rate was 50%. Then the windfall profit tax would be 20 on A and 0 on B, while the company's net income would be 0 (100 on A minus 100 on B) without subtracting the windfall profit tax liability. If the loss on B were 200 in the same example, the windfall profit tax liability would remain 20, and the company-wide net income (without subtracting that liability) would be −100. Cf. Pltf. Jt. App. 616a-658a (In 1981, appellant Cities Service had a windfall profit tax liability of more than $300,000,000 but only about $14,000,000 in federal taxable income on line 28 of the federal return, arrived at after subtracting the windfall profit tax liability.); J.S. App. 84a (In 1981, appellant Cities Service would have incurred no New Jersey income tax liability if the windfall profit tax had been excluded from New Jersey's income tax base.).

Unless otherwise noted, "J.S. App." refers to the appendix to the jurisdictional statement in No. 87-453.

[3] Some of the rates have decreased since 1981, and the tax is to be eliminated by 1993. I.R.C. §§ 4987(b)(3), 4990(c).

the imposition of combined income and excise taxes in excess of the taxpayer's gross windfall profit." S. Rep. 96-394, *supra*, at 68; see H.R. Rep. 96-304, *supra*, at 43-44. The portion of the "windfall profit" remaining after subtraction of the windfall profit tax paid to the Government is joined with the company's other income and made subject to federal income tax.

B. The State of New Jersey imposes a corporation business tax on the apportioned share of a corporation's "entire net income" for the privilege of "doing business, employing or owning capital or property, or maintaining an office" in the State. N.J. Stat. Ann. §§ 54:10A-2, 54:10A-8 (West 1986).[4] For taxpayers doing business in more than one State, the tax liability is determined by multiplying (a) the taxpayer's company-wide "entire net income" by (b) a fraction representing the share of the taxpayer's income properly apportioned to New Jersey by (c) the tax rate (nine percent). *Id.* § 54:10A-5(c). The apportionment fraction – which, like the tax rate, is not challenged – is derived by the standard three-factor formula averaging the ratios of in-State to out-of-State payroll, receipts, and real and tangible property. *Id.* § 54:10A-6. The "entire net income" of a multistate corporation is presumptively the same as the federal taxable income on line 28 of the federal tax return (*id.* § 54:10A-4(k)), but a number of modifications to that figure are required under the so-called "add-back" provision. In particular, the "entire net income" subject to apportionment " shall be determined without the * * * deduction * * * of * * * [t]axes paid or accrued to the United States on or measured by profits or income" (*id.* § 54:10A-4(k)(2)(C)).[5]

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[4] For the years at issue in these cases, the state tax was also imposed on a similarly apportioned share of taxpapers' "entire net worth." N.J. Stat. Ann. § 54:10A-5(a) (West 1986). That portion of the tax is not at issue in these cases.

[5] The New Jersey Supreme Court stated that the provision requiring modification of federal taxable income to arrive at entire net income "is called the 'add-back' provision" (J.S. App. 2a). This is an accurate short-hand description of the way entire net income is calculated: the windfall profit tax is added back to the federal line-28 taxable income. Of course, the constitutional analysis in these cases turns on the actual operation of the provision, and not on its label.

C. Appellants are vertically integrated oil companies that engage in all aspects of the crude oil business, including exploration, production, refining, and marketing. All market their petroleum products and some refine oil in New Jersey; all produce oil outside of New Jersey. Neither appellants nor any other companies produce oil in New Jersey, which has no proven oil reserves. J.S. App. 2a; Comm. on State Taxation et al. Amici Br. 5 n.2.

In reporting their "entire net income" to New Jersey for 1980 and 1981, appellants did not add back to their federal taxable income the windfall profit taxes they had paid to the United States, taxes they had properly deducted in calculating their federal taxable income. New Jersey's Director of the Division of Taxation, appellee in these cases, required the inclusion of the windfall profit tax amounts in the entire net income on the ground that the windfall profit tax was a tax "on or measured by profits or income" under N.J. Stat. Ann. § 54:10A-4(k)(2)(C) (West 1986). The companies thereafter brought suit in the Tax Court of New Jersey, contending that the federal windfall profit tax did not come within the New Jersey add-back provision and that it could not do so without violating the federal Constitution or frustrating the policies of the Crude Oil Windfall Profit Tax Act of 1980. J.S. App. 6a-7a; 87-453 J.S. 8-9; 87-464 J.S. 4-5.

The Tax Court of New Jersey upheld the deficiency assessments of the Director (J.S. App. 43a-49a, 50a-61a). The Superior Court of New Jersey, Appellate Division, reversed the Tax Court on state-law grounds (*id.* at 36a-42a). The Supreme Court of New Jersey reversed and reinstated the judgment of the Tax Court. (*id.* at 1a-35a).

The state Supreme Court devoted most of its opinion to explaining why, as a matter of state law, the windfall profit tax was a tax "on or measured by profits or income" and was therefore not deductible in defining the "entire net income" subject to apportionment (J.S. App. 10a-31a). The court observed that the add-back provision had been enacted in 1958, long before the federal windfall profit tax was created, so that there was no specific legislative intent towards the federal tax (*id.* at 3a). The court then reasoned that the federal tax was "measured

by profits or income" both literally and economically. The windfall profit tax, the court concluded, was imposed on a part of true net income (*i.e.*, receipts minus costs): first, the measure of the tax could not exceed 90% of the per-barrel net income; and in any event, the measure of the tax was only the excess over the controlled price, which was itself apparently adequate to ensure cost recovery to appellants. *Id.* at 16a-29a.

On the federal questions presented, the court ruled that the 1980 Act did not preempt application of the add-back provision to the windfall profit tax (J.S. App. 34a-35a)[6]; the court then rejected appellants' due process, Commerce Clause, and equal protection challenges. The court rejected the due process challenge simply by noting that appellants conceded that they were unitary businesses, that only a deduction from and not an addition to the "net income tax base" was at issue, and that the three-factor apportionment formula reduced the tax base to what was properly attributable to New Jersey (*id.* at 33a-34a). With respect to the Commerce Clause, the court held that there was no violation because denying a deduction for the windfall profit tax "does not favor in-state over out-of-state economic activity" or otherwise "discriminate against interstate commerce" (*id.* at 34a). Finally, the court concluded that appellants had not been denied equal protection relative to non-producing marketers, explaining that the latter did not pay the windfall profit tax, did not benefit from decontrol, and indeed had to pay higher prices in purchasing crude oil (*ibid.*).

DISCUSSION

A. This Court has noted that the Constitution imposes " 'extremely limited restrictions' " on States' powers of taxation. *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450, 457 (1959) (citation omitted). Those restrictions cluster around two related principles – that States are forbidden to impose extraterritorial taxes or taxes that discriminate against interstate commerce. In its numerous decisions in this area, the Court has articulated in various ways how those principles apply

[6] Appellants have not renewed that argument in this Court.

in different contexts, noting that "the result turns on the unique characteristics of the statute at issue and the particular circumstances in each case" (*Boston Stock Exchange* v. *State Tax Comm'n*, 429 U.S. 318, 329 (1977)).

1. The Due Process and Commerce Clauses require a State to limit its taxes to in-State values: "As a general principle, a State may not tax value earned outside its borders." *ASARCO Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982); see *Connecticut Gen. Life Ins. Co.* v. *Johnson*, 303 U.S. 77, 81 (1938); *Western Union Tel. Co.* v. *Kansas*, 216 U.S. 1, 26-27, 35, 37-38, 47 (1910). This principle requires, most basically, "a 'minimal connection' or 'nexus' between the interstate activities and the taxing State." *Exxon Corp.* v. *Department of Revenue*, 447 U.S. 207, 219 (1980); see *Tyler Pipe Industries, Inc.* v. *Washington State Dep't of Revenue*, No. 85-1963 (June 23, 1987), slip op. 16-17; *Mobil Oil Corp.* v. *Commissioner of Taxes*, 445 U.S. 425, 436-437 (1980); *Moorman Mfg.* v. *Bair*, 437 U.S. 267, 273 (1978); *Northwestern Cement*, 358 U.S. at 464-465. In addition, the measure of a State's tax must be rationally related to the taxpayer's in-State activities (and hence to the protections and benefits afforded by the State). *Commonwealth Edison Co.* v. *Montana*, 453 U.S. 609, 622-626 (1981); *Moorman Mfg.*, 437 U.S. at 273; *Complete Auto Transit, Inc.* v. *Brady*, 430 U.S. 274, 279 (1977); *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 444 (1940). A tax imposed on a multistate business must accordingly be so limited as to tax only business that is fairly attributable to the State: the tax must be fairly apportioned. *Container Corp. of America* v. *Franchise Tax Bd.*, 463 U.S. 159, 171 (1983); *Exxon Corp.*, 447 U.S. at 220; *Complete Auto*, 430 U.S. at 279; *Butler Bros.* v. *McColgan*, 315 U.S. 501, 506-507 (1942); *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920); *Western Union*, 216 U.S. at 30-31.

In one important line of decisions that apply those principles to taxes that fall on multistate businesses, the Court has addressed the potential for multiple taxation by holding or stating that certain transactions or events are so inherently locale-specific as not to be subject to taxation by more than one State.

Thus, the Court has indicated that only the State where the activity of selling takes place may tax the activity itself at its full value — namely, gross receipts from the sale. *Tyler Pipe*, slip op. 18 (citing *Moorman Mfg.*, 437 U.S. at 280-281; *Standard Pressed Steel Co.* v. *Washington Revenue Dep't*, 419 U.S. 560, 564 (1975)). The Court has also observed that the activity of severance of coal is subject to taxation on its full value — the value of the coal — only in the State where the coal is mined. *Commonwealth Edison*, 453 U.S. at 617. See also *Evco* v. *Jones*, 409 U.S. 91 (1972). Apportionment problems are cured, of course, if only one State may tax a particular activity in that State.

The more common way of addressing apportionment problems raised by taxes on multistate businesses' *income* is use of the formula-apportionment method of determining each State's proper share of the income. Under this method, a State begins with company-wide income (from some or all sources) and multiplies that figure by a fraction used to approximate the local share of business. This Court has generally upheld that method against broad claims that it allows States to tax too much or insufficiently related income.

Thus, the Court has permitted inclusion in the formula of all company income — out-of-State and in-State, foreign and domestic — even when the company keeps separate accounts for different sources of income and even when the business is not a single corporation. See *Container Corp.*, 463 U.S. at 175-183 (upholding inclusion of foreign income); *Exxon Corp.*, 447 U.S. at 220-230 (upholding apportionment formula even though company used separate accounting for production, refining, and marketing, only last of which occurred in the taxing State); *Mobil Oil Corp.*, 445 U.S. at 438-448 (upholding inclusion of dividend income); *Northwestern Cement*, 358 U.S. at 459 (upholding inclusion of income from interstate commerce); *Underwood Typewriter*, 254 U.S. at 116-120.[7] The Court has

[7] At the same time, the Court has not forbidden separate accounting in preference to formula apportionment. In *Atlantic Richfield Co.* v. *Alaska*, 705 P.2d 418 (Alaska 1985), appeal dismissed, 474 U.S. 1043 (1986), the Alaska Supreme Court rejected several challenges to Alaska's taxing scheme, which

approved general use of the common three-factor fraction (receipts, wages, and real and tangible property) (see *Container Corp.*, 463 U.S. at 170) and of certain single-factor fractions (*Moorman Mfg.*, 437 U.S. 267 (sales); *Underwood Typewriter*, 254 U.S. 113 (property)).

The Court has insisted, however, that the formula-apportionment method may be applied only to the income from a "unitary" business: the formula may not include income from a "discrete business enterprise" (*Mobil Oil Corp.*, 445 U.S. at 439-441) or from otherwise unrelated activities of the taxpayer. See *Container Corp.*, 463 U.S. at 166; *Exxon Corp.*, 447 U.S. at 223-226; *ASARCO Inc.*, 458 U.S. 307; *F. W. Woolworth Co.* v. *Taxation & Revenue Dep't*, 458 U.S. 354 (1982). The Court has long recognized that if, but only if, a business is unitary, it is likely impossible (as a practical and perhaps even theoretical matter) to determine the geographic source of particular net income, because all activities of an integrated business make some contribution to the production of income throughout the business. *Container Corp.*, 463 U.S. at 164; *Butler Bros.*, 315 U.S. at 506-507; *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Comm'n*, 266 U.S. 271, 282 (1924). Accordingly, although the formula-apportionment method is inherently imprecise and States' use of different formulas may produce some multiple taxation (see *Container Corp.*, 463 U.S. at 171, 183, 187; *Moorman Mfg.*, 437 U.S. at 278), the Court has required taxpayers complaining that unfair apportionment has resulted in the taxation of extraterritorial values to show "by 'clear and cogent evidence' " that the income attributed to the State is " 'out of all appropriate proportion[ ]' " to the business transacted in the State (*Moorman Mfg.*, 437 U.S. at 274; see *Exxon Corp.*, 447 U.S. at 220; *Butler Bros.*, 315 U.S. at 507). See also *Hans*

excluded oil production income from the general formula-apportionment method and imposed a separate income tax on such income. The taxpayers appealed on the ground, among others, that the Constitution prohibited separate accounting for production income and required it to be included in the apportionment formula. 85-773 J.S. i. The Court dismissed the appeal for want of a substantial federal question, with three Justices dissenting. 474 U.S. 1043 (1986).

Rees' Sons v. *North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931) (State may not tax 66-85% of income where only 17% is properly attributed to the State).

2. The Commerce Clause, along with the Equal Protection Clause and the Privileges and Immunities Clause of Article IV, prohibits certain forms of discriminatory taxation that place obstacles in the way of interstate commerce. See *Container Corp.*, 463 U.S. at 171; *Complete Auto*, 430 U.S. at 279; *Western & Southern Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648, 655, 667-668 (1981); *Travis* v. *Yale & Towne Mfg.*, 252 U.S. 60 (1920). Thus, this Court has struck down state laws that discriminate against non-residents, that impose higher taxes when a transaction crosses state lines than when it is purely intrastate, that give a commercial advantage to businesses by virtue of their in-State activities or disadvantage by virtue of their out-of-State activities, or that otherwise place an "inexorable hydraulic pressure on interstate businesses to ply their trade within the State." *American Trucking Ass'ns, Inc.* v. *Scheiner*, No. 86-357 (June 23, 1987), slip op. 19. See *Northwestern Cement*, 358 U.S. at 458. Although States may impose taxes on interstate businesses and may justify certain kinds of different treatment, they may not impair the constitutional "guarantee of a free trade area among States" by imposing a tax that "has a clearly discriminatory effect on commerce by reason of that commerce's interstate character" (*American Trucking Ass'ns, Inc.*, slip op. 13, 28-29).

For example, in *Boston Stock Exchange* v. *State Tax Comm'n, supra*, a State, as part of its tax on in-State stock transfers made after stock sales, granted non-residents a 50% tax reduction if the sale (as well as the transfer) took place in-State and placed a ceiling on total transfer tax liability for all in-State sales. The Court held the tax unlawfully discriminatory because it provided an incentive for all non-residents and for some residents (those whose sales would exceed the ceiling) to divert their out-of-State sales into the State (429 U.S. at 330-336).[8] In *Maryland* v. *Louisiana*, 451 U.S. 725 (1981), the Court invalidated a natural-gas tax from which in-State users were at least partly exempt, finding that the tax had the obvious effect of encouraging more in-State activity (*id.* at 756-757). In *Westinghouse Electric Corp.* v. *Tully*, 466 U.S. 388 (1984), the Court held invalid a provision of a state income tax that allowed a credit to certain taxpayers if they shipped certain foreign-destination goods from the taxing State rather than from another State. The Court observed that the tax plainly attempted to induce business to be performed in the State that might more efficiently be performed elsewhere (*id.* at 406-407), that there was no economic difference between merely denying a credit to certain taxpayers and raising their taxes (*id.* at 404-405), and that the discrimination bar applied even if the state tax otherwise included a fair apportionment formula (*id.* at 398-399). In *Metropolitan Life Ins. Co.* v. *Ward*, 470 U.S. 869 (1985), the Court held that a State could not validly impose lower taxes on in-State insurance companies or give tax breaks based on in-State investments in order to encourage the formation of in-State companies or investment in in-State assets.[9]

Most recently, in *Tyler Pipe Industries, Inc.* v. *Washington State Dep't of Revenue, supra*, this Court struck down a tax that granted a manufacturing-tax break to in-State manufacturers, but not to out-of-State manufacturers, who sold their goods wholesale in the State. Noting that the tax break could not be defended as compensation for double taxation because no account was taken of out-of-State manufacturing taxes (slip op. 9-10, 16), the Court held that this "facially discriminatory" tax failed the test of "internal consistency": if applied by all States,

[8] Discrimination against non-residents was also struck down in *Wheeling Steel Corp.* v. *Glander*, 337 U.S 562 (1949), where the Court invalidated a state tax on non-residents' accounts receivable from in-State business, rejecting the State's reciprocity defense that other States might treat their residents similarly (*id.* at 573). See also *Williams* v. *Vermont*, 472 U.S. 14 (1985).

[9] In *Western & Southern Life Ins. Co.* v. *State Bd. of Equalization*, 451 U.S. 648 (1981), by contrast, after explaining that the McCarran-Ferguson Act, 15 U.S.C. 1011 *et seq.*, removed any passive Commerce Clause limitations on state insurance taxes, the Court rejected an equal protection challenge to a state insurance tax, explaining that the tax was legitimately designed to discourage other States from erecting barriers to interstate insurance business.

business that crosses state lines would be subject to higher taxes than purely intrastate businesses (*id.* at 14-15). See also *Armco Inc.* v. *Hardesty*, 467 U.S. 638 (1984). And in *American Trucking Ass'ns, Inc.* v. *Scheiner, supra,* the Court struck down a State's flat tax on all trucks that used the State's roads, where out-of-State truckers on average used the roads only one-fifth as much as in-State truckers (slip op. 8-9, 29). The Court observed that a State may not impose a "heavier tax burden on out-of-State businesses that compete in an interstate market than it imposes on its own residents who also engage in commerce among States" (*id.* at 15 (footnote omitted)). Although the tax was not facially discriminatory and not all out-of-State truckers suffered the disproportionately higher per-mile tax than all in-State truckers (*id.* at 18-19), the Court held the tax invalid because it failed the internal consistency test: if applied by all States, it would inevitably deter interstate business, because two truckers traveling the same number of miles would pay different taxes depending solely on whether they crossed state lines (*id.* at 17).[10]

B. 1. We begin our analysis of appellants' claim by noting all that is not at issue in these cases. Appellants do not challenge the appropriateness of the State's use of the unitary-business formula-apportionment method for its corporate income tax or the State's selection of the three-factor payroll/property/receipts apportionment fraction. They do not deny that their oil-producing operations are parts of unitary businesses that have a sufficient connection with the State. See *Exxon Corp.* (integrated petroleum businesses unitary); *Mobil Oil Corp.* (same). Nor do they challenge the New Jersey taxing scheme as "facially discriminatory," since the State has not expressly rested any feature of its tax on the in-State or out-of-State character of companies, transactions, or goods. Compare *Tyler Pipe*; *Westinghouse Electric Corp.*; *Maryland* v. *Louisiana*; *Boston Stock Exchange*.

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[10] See, *e.g.*, *Tyler Pipe*, slip op. 12-15; *Container Corp.*, 463 U.S. at 170; *Moorman Mfg.*, 437 U.S. at 275-278; *Northwestern Cement*, 358 U.S. at 458; *Gwin, White & Prince, Inc.* v. *Henneford*, 305 U.S. 434, 439 (1939); *Western Live Stock* v. *Bureau of Revenue*, 303 U.S. 250, 255 (1938).

Despite some characterizations that might suggest otherwise,[11] appellants do not expressly raise an intent-based challenge to the New Jersey decision at issue here, and we doubt that any such challenge could succeed. First, it is the federal government that first "singled out" those who produce oil for special tax treatment. Moreover, the New Jersey add-back provision, which applies to all federal taxes measured by profits or income, is certainly "unobjectionable on its face" (87-453 Mot. to Aff. 9), and the state legislature had no intent towards the windfall profit tax, which was enacted long after the add-back provision (J.S. App. 3a). Finally, the New Jersey Supreme Court construed the provision as it did because of its view that the windfall profit tax was indeed measured by profits and that disallowing its deduction preserved for New Jersey the same full net-income base that the federal government taxes (albeit in two stages – first, the windfall profit tax, then the income tax) (*id.* at 16a-29a). In short, there is no reason to suspect any local favoritism, protectionism, or other motivation that may justify special judicial scrutiny.

This conclusion is reinforced by the fact that, although New Jersey's method of calculating entire net income results in a distinction between integrated oil companies, which produce oil, and the non-producing independent marketers with which they compete, that distinction does not *coincide* with an in-State/out-of-State distinction. Appellants do not dispute that there are independent marketers that are out-of-State companies and that are engaged in interstate business, as in *Exxon Corp.* v. *Maryland*, 437 U.S. 117 (1978). And appellant integrated producers have very substantial presences in New Jersey, including refining and chemical operations (see Pltf. Jt. App. 1129a-1137a).[12]

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[11] Appellants state that New Jersey has geographically "tailored" its tax (87-453 J.S. 12, 15, 17, 18), has "gerrymander[ed]" its tax base (*id.* at 12), has "single[d] out" certain out-of-State activity for special treatment (*id.* at 17, 19, 26), has "tamper[ed] in a geographically selective manner" with its tax base (*id.* at 13).

[12] At least one appellant, Exxon Corporation, is a New Jersey corporation. Pltf. Jt. App. 1134a.

Further, the facially neutral deduction denial at issue here does not create either of two forms of discrimination against interstate commerce that were created by the statutes struck down in *Boston Stock Exchange*, *Maryland* v. *Louisiana*, *Westinghouse Electric Corp.*, and *Tyler Pipe*. First, the New Jersey decision at issue cannot produce an incentive for appellants to move their out-of-State oil production activity into the State, because oil production cannot be moved into a State with no proven reserves. Second, if all States followed New Jersey's treatment of windfall profit taxes, oil producers would not thereby be given an incentive to confine oil production to a single State. Producers would, of course, be taxed on a higher base than if all States allowed the deduction; but the same overall level of oil production would create the same tax base (all other things being equal) whether it took place in several States or in one. The New Jersey add-back of windfall profit taxes thus passes at least that version of the internal consistency test.[13]

2. Appellants contend that New Jersey has geographically skewed the definition of pre-apportionment net income by denying a deduction for a "business expense" or "cost" (*e.g.*, 87-453 J.S. 12, 18) that is incurred on account of a locale-specific activity (oil production) that neither appellants nor any other New Jersey taxpayer conducts in the State.[14] Disallowing the deduction, they urge, effectively imposes a state tax,

[13] The Court has not suggested that the internal consistency test is the sole test of constitutionality. Moreover, in *Container Corp.*, 463 U.S. at 169, the Court described the "internal consistency" test as asking whether a tax, "if applied by every jurisdiction, * * * would result in no more than all of the unitary business' income being taxed." To the extent appellants are correct that windfall profit taxes represent a true economic cost, New Jersey's denial of the deduction for the taxes would mean that it was taxing more than its share of true net income; and if all States followed New Jersey's lead, even with fair apportionment, appellants would be subject to aggregate taxation on more than 100% of their true net income. The same result would occur, however, if the business were located wholly in one State. Whether there is nonetheless a constitutional problem we discuss below.

[14] Throughout this brief, we use the term "geographic skewing" or "geographically skewed" to refer to disparities between in-State and out-of-State effects.

triggered by the activity of removing oil from out-of-State producing properties, on a "percentage of the value of the crude oil produced in another state" (87-453 J.S. 23), as if New Jersey had imposed its own apportioned windfall profit tax on the activity of out-of-State oil production (*id.* at 21; 87-464 J.S. 16-17). This violates extraterritorial principles, they say, because the taxed activity of "removal" has no nexus to New Jersey, the measure of the tax (a portion of value at the producing property) bears no fair relationship to appellants' New Jersey activities, and denying a deduction for an exclusively out-of-State "cost" results in an unfair apportionment to New Jersey of unitary income. See 87-453 J.S. 18-24; 87-464 J.S. 9-17. Discrimination principles are also violated, appellants argue, because New Jersey has imposed a higher tax burden on some taxpayers because of their out-of-State activities, with the direct result that appellants' non-producing competitors in marketing are subject to a lower effective rate than are appellants (87-453 J.S. 24-30).

3. Appellants' challenge does not fall neatly into the doctrinal categories elaborated by this Court. This Court's decisions indicate, however, that a state tax measure may in some circumstances violate the Constitution because of its formal operation (its incidence, measure, and rate) and its economic effects, even though it is not facially discriminatory or ill-motivated.[15] Whatever the proper label for their claim, and whatever its ultimate merits, appellants' challenge raises a federal question worthy of plenary review by this Court.[16]

[15] See *American Trucking Ass'ns*, slip op. 18-19, 29; *Tyler Pipe*, slip op. 18; *Commonwealth Edison Co.*, 453 U.S. at 615; *Maryland* v. *Louisiana*, 451 U.S. at 756; *Exxon Corp.*, 447 U.S. at 227-228; *Mobil Oil Corp.*, 445 U.S. at 443; *Complete Auto*, 430 U.S. at 279, 281; *Shaffer* v. *Carter*, 252 U.S. 37, 55 (1920); *Western Union*, 216 U.S. at 27.

We also note that three of the seven other States in which the question presented here has arisen (Minnesota, North Dakota, and Wisconsin) have expressly denied a deduction for the windfall profit tax in their statutes. See J.S. App. 85a-91a.

[16] The immediate practical importance of these cases is apparently limited to the precise question of the deductibility of the windfall profit tax. More than $88 million is at stake for New Jersey (87-453 Mot. to Aff. 11 n.8) and

a. Appellants correctly suggest that a State's facially neutral denial of a deduction for a particular site-specific cost that was and could be incurred only out-of-State would raise substantial constitutional questions. This Court's decisions on the unitary-business formula-apportionment method have considered what parts of a business, with all associated receipts and costs, may fairly be included in pre-apportionment income; and in that context, it has rejected challenges based on geographic skewing. *E.g.*, *Container Corp.*; *Exxon Corp.*; *Mobil Oil Corp.*; see also *Atlantic Richfield Co.* v. *Alaska*, 474 U.S. 1043 (1986) (dismissing appeal). But the Court has not previously been presented with a claim like appellants' – that a State has asymmetrically included receipts without allowing deductions for associated costs. The Court has, however, noted that a tax "tailored" to give special treatment to particular businesses (*e.g.*, those which incur particular costs) raises special dangers of invalidity and demands special judicial scrutiny (*Complete Auto*, 430 U.S. at 288 n.15). (As we have noted (page 13, *supra*), there is no intentional *legislative* tailoring here, but the law at issue may operate with the same effect.)

Although the several pertinent constitutional requirements this Court has articulated – nexus of the taxed activity to the State, fair relationship to the State of the measure of the tax, fair apportionment, and non-discrimination (see *Commonwealth Edison*, 453 U.S. at 626; *Complete Auto*, 430 U.S. at 279) – are related, the constitutional difficulty with denying a

several times that amount for the seven other States where the question has arisen (J.S. App. 85a-91a). We also think it appropriate to disclose that, because state income taxes are deductible for federal tax purposes (I.R.C. § 164), the United States has a large financial interest in these cases directly adverse to that of the State.

Aside from the windfall profit tax, appellants and their amici correctly argue that the ruling of the New Jersey Supreme Court increases the likelihood that States will deny deductions for other exclusively out-of-State site-specific costs. Appellants' amici express concern, in particular, that States might begin denying deductions for federal taxes or other States' taxes on the activity of severing minerals from the ground or on harbor use, both obviously site-specific. Comm. on State Taxation et al. Amici Br. 7-11; Amer. Min. Cong. Amicus Br. 5-8. Amici do not point to any State that has adopted such practices.

deduction for a site-specific cost does not seem to us a problem of insufficient nexus of the taxed activity to the State or unfair relation of the measure of the resulting tax to State benefits. In this regard, the problem is different from that presented by one State's directly taxing severance or sales in another State. Such taxes are forbidden (see pages 7-8, *supra*) because their subject matter (the activity of severance or sale) and their measure (the "full value" of the severance or sale (*Tyler Pipe*, slip op. 18)) have an insufficient connection to any State except the State of severance or sale. Other States, however, plainly have a sufficient nexus with *portions* of the value of even a site-specific activity – notably, the portion that represents the income generated by the activity; otherwise, the unitary-business formula-apportionment method could not be applied to any item that had been subject to a severance or sales tax by another State. Thus, when a State denies a deduction in calculating a pre-apportionment company-wide figure as part of formula apportionment, the subject matter of the resulting tax is still some form of company-wide activity (net income or something else); and if the cost-producing activity is conducted by a unitary business, the State has a sufficient nexus with that subject matter. Moreover, the measure of the resulting tax could well be some figure that, given unitariness, fairly depends in part on the company's activities in the taxing State, as a severance or sales tax, under this Court's decisions, would not.[17]

[17] Contrary to appellants' suggestion (87-453 J.S. 21; 87-464 J.S. 16-17), therefore, the effect of New Jersey's deduction denial here is not identical to the effect that would be produced by the State's imposition of its own apportioned windfall profit tax. Such a tax, like a severance tax or the federal windfall profit tax itself, would be incurred on particular properties without any offset for losses on other properties. By contrast, where a deduction for a site-specific cost is denied in calculating unitary income, losses from the rest of the business are fully offset before any tax is imposed. Thus, while a producer can incur a federal windfall profit tax liability even though it has more than offsetting net losses company-wide for a particular tax year, there would be no New Jersey "entire net income" in such a situation. The tax effect of a deduction denial like New Jersey's does not turn exclusively on a specific out-of-State activity but depends also on the other activities of the unitary business in New Jersey and elsewhere in the tax year.

Accordingly, when a State denies a deduction for a particular cost, we doubt that a constitutional problem (a nexus or fair-relationship problem) results simply by virtue of the fact that the cost is incurred out-of-State. A problem may arise, however, when a State denies a deduction for a cost that is incurred so disproportionately out-of-State (*e.g.*, exclusively) that the constitutional principles of fair apportionment and nondiscrimination,[18] which require comparison of in-State and out-of-State events, are implicated. It is the skewing of a unitary-business apportioned income tax that may present a difficulty. Skewing of this sort was presented in *Westinghouse Electric Corp.*, where a State granted a credit, in its apportionment formula, that depended on whether certain activities took place in the State or elsewhere. That case, unlike these, involved a traditional Commerce Clause bar on a facial discrimination that encouraged the transfer of a business activity into the taxing State, but an analogous problem may arise at least when a taxpayer is not permitted to deduct a cost that can be incurred only out-of-State (lesser disparities not being squarely at issue in these cases).

The heart of the problem is this: although, by assumption, the State could not hope to encourage the transfer of the cost-producing activity into the State, it would nonetheless be granting to those conducting activities in the State a reduced-fare (if not a free) ride for the benefits of state government -- just as surely as if it had required a doubling of revenues received out-of-State. That is the core of appellants' claim, but we note that the practice might at least theoretically also have certain secondary consequences that this Court has discussed (though these may not be of *independent* legal significance). It could create an incentive to shift resources away from the out-of-State cost-producing activity (*e.g.*, oil production) and into an activity that did not incur the special tax burden – perhaps an in-State activity (*e.g.*, refining, marketing, chemical manufacture). See 87-453 J.S. 20 (the greater the out-of-State activity, the greater the tax effect); *Maryland* v. *Louisiana*, 451 U.S. at 757 (tax credit un-

[18] See *Armco Inc.*, 467 U.S. at 644 ("A tax that unfairly apportions income from other States is a form of discrimination against interstate commerce.").

constitutionally encourages investment in in-State mineral exploration and development rather than out-of-State gas production). Efficiency-based business decision-making could be distorted. See *Westinghouse Electric Corp.*, 466 U.S. at 406. And if States generally began to exploit out-of-State activities in this manner, with different States denying deductions for different costs, there could result a substantial impairment of free trade. See 87-453 J.S. 26.

For these reasons, it seems to us incorrect to argue, as appellee appears to do (87-453 Mot. to Aff. 14-15, 17-18; 87-464 Mot. to Aff. 4), or to conclude, as the New Jersey Supreme Court appears to have done (J.S. App. 33a-34a), that there can be no constitutional problem as long as a State is merely denying deductions and does not tax more than gross receipts. Geographic skewing of deductions may present a constitutional difficulty even if no taxpayer is taxed on more than gross receipts.

b. Before determining that a State deduction denial is invalid because of its geographic skewing, caution is clearly in order. The Court has long recognized that States have broad leeway to define their taxing systems generally and to depart from federal definitions of income in particular. See *Northwestern Cement*, 358 U.S. at 457; *Nashville, C. & St. L. Ry.* v. *Browning*, 310 U.S. 362, 365 (1940); *Bass, Ratcliff*, 266 U.S. at 283; *Shaffer* v. *Carter*, 252 U.S. 37, 51 (1920). It has held that various apportionment methods are permissible despite their inherent imprecision and the potential for duplicative taxation created by different States' use of different methods. See, *e.g.*, *Container Corp.*, 463 U.S. at 171; *Mobil Oil Corp.*, 445 U.S. at 448; *Moorman Mfg.*, 437 U.S. at 274.[19] It also has stated that there is no single correct way to define net income and that the

[19] As we have noted, in none of the decisions in which this Court has declared acceptable the imprecisions of formula-apportionment methods of taxing unitary businesses was there a claim like appellants' of geographically skewed treatment of different sources of income. Such treatment could greatly magnify such imprecisions. It may be that the absence of pronounced skewing is a necessary premise of the acceptability of formula-apportionment methods.

Constitution does not require a uniform definition. See *Moorman Mfg.*, 437 U.S. at 278-279 (some multiple taxation for unitary businesses is permitted because, inter alia, the Court would otherwise have to set uniform rules for state taxes, including rules for the definition of pre-apportionment income). And it has set a high standard for a concededly unitary business to sustain an attack on a State's tax as unfairly apportioned, requiring that the taxpayer show that the apportioned share is "out of all appropriate proportion" to the share of business "actually" conducted in the State (see *Container Corp.*, 463 U.S. at 175; *Moorman Mfg.*, 437 U.S. at 274).

In addition, as appellee suggests (87-453 Mot. to Aff. 15), there are important practical reasons for caution about challenges to States' disallowance of deductions for particular costs. States have various methods of calculating pre-apportionment income.[20] Some "singled out" deductions doubtless have differential out-of-State effects on particular taxpayers, on groups of taxpayers, or on all taxpayers to whom they apply. Some deductions are almost by definition industry-specific—*e.g.*, for oil depletion or intangible drilling costs. Thus, appellants' challenge based on the geographical bias of the windfall profit tax element of the "entire net income" definition presents the prospect of other challenges to other elements of the pre-apportionment income definition by appellants and by other taxpayers with costs or income sources that are site-specific and located exclusively out-of-State. And since what activities take place in a State may change over time, the argument put forth by appellants might require, as a matter of constitutional law, corresponding changes in the State's tax laws.

[20] According to one commentator (1 J. Hellerstein, *State Taxation* (1983)), States deviate in a variety of ways from the use of federal taxable income as a measure of apportionable income—by, for example, declining to gr[illegible] preferential treatment to long-term capital gains (¶ 7.6), superimposing their own depreciation and depletion allowances (¶ 7.7), disallowing the carryover or carryback of deductions for net operating losses (¶ 7.3), denying a foreign tax credit (¶ 7.9), or denying the federal "dividends received" deduction (¶ 7.5) or deductions for expenses attributable to income not taxed by the State (¶ 7.8) or for foreign taxes paid (¶ 7.9) or for state and local taxes measured by net income (¶ 7.10).

The above reasons for caution warrant full consideration at the merits stage of these cases, with particular attention to the practical implications of recognizing the validity of appellants' claim. Practicalities have often played a role in the Court's definition of constitutional standards (*e.g.*, *Container Corp.*, 463 U.S. at 185-186; *Moorman Mfg.*, 437 U.S. at 278-279). And it may be that the reasons for caution we have sketched present insurmountable objections to appellants' claim. It is important to note, however, that the challenge we consider substantial here is narrowed by several inherent limitations.[21]

First, the challenge applies only to costs that are properly identified as site-specific, those whose amount increases directly with the level of activity that is identifiably out-of-State. We doubt, for example, that interest payments on an integrated company's debts should be considered site-specific. On the other hand, under this Court's decisions, a severance tax would seem intrinsically site-specific.

[21] These cases involve only a problem of geographic skewing. It light of appellee's broad suggestion that a State may freely tax any amount up to gross receipts, we note that there may also be other limits, not involved here, on a State's disallowance of deductions in a unitary-business formula-apportionment tax. Notably, as more and more costs are disallowed, the pre-apportionment figure moves away from "net income" and toward gross revenues. Yet, while this Court has suggested that some gross receipts taxes may be imposed by "apportionment" methods such as mileage ratios for multistate transportation companies (see, *e.g.*, *Central Greyhound Lines, Inc.* v. *Mealey*, 334 U.S. 653, 663 (1948); *Gwin, White & Prince*, 305 U.S. at 439), it has not generally considered whether a State may tax a unitary business's gross receipts by multiplying company-wide receipts by ratios like that used by New Jersey (payroll, receipts, property). Cf. *Armco Steel Corp.* v. *Michigan*, 359 Mich. 430, 102 N.W.2d 552, appeal dismissed, 364 U.S. 337 (1960) (apportioned tax on "adjusted receipts," permitting deduction for many costs but not for payroll and depreciation).

Any such tax would create a risk [illegible]tiple taxation, because the in-State receipts are fully taxable by the State [illegible]ey are received (*e.g.*, *Tyler Pipe*, slip op. 18). And although it might be argued that the actual in-State receipts are not the best measure of the State's contribution to company-wide receipts, the practical justification for using an apportionment formula is considerably weaker for gross receipts than for income. That justification rests to a large degree on the difficulty of identifying the State in which *profits* (the net of revenues over costs) are generated (*Container Corp.*, 463 U.S. at 164, 166);

Second, contrary to the apparent suggestion of appellants Texaco and Tenneco (87-464 J.S. 9-17), even for an out-of-State cost, no complaint is justified simply because the State denies a deduction for the cost. Rather, the challenge depends on an in-State/out-of-State comparison of the incidence of that cost, so that if the State treats comparable in-State costs in the same manner, there may be no constitutional problem. For example, a State where significant oil production occurs could deny deductions for specified oil production costs; and a non-copper-producing State might permissibly deny a deduction for other States' copper severance taxes if it denied a deduction for *all* severance taxes and it had, for example, substantial coal severance activity and its own coal severance tax. In short, it should remain open to a State to defend a deduction denial by showing that it is comparable to other deduction denials for costs that are incurred in-State.[22]

Third, these cases involve a cost that is incurred exclusively out-of-State, so the Court need not rule on cases involving less stark skewing. Because some exploration of the limits of appellants' challenge would be necessary on plenary review, however, we note that there would be a firm basis in this Court's decisions for limiting the challenge to cases that involve geographic skewing that is pronounced and systemic, and not limited to particular taxpayers based on the fortuity of the locations of parts of their businesses. This standard would be met at

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but receipts are one of the standard elements of the three-factor apportionment fraction precisely because their location is objectively measurable with reasonable certainty.

[22] It may be possible for even a gross geographic skewing of a state tax measure to be justified on other grounds, perhaps as needed to serve certain regulatory objectives. *Exxon Corp.* v. *Maryland*, *supra*, on which appellee relies (87-453 Mot. to Aff. 21-22), may provide an illustration. There, the State imposed a burden on integrated oil companies on account of their exclusively out-of-State activities (oil production), but it did so because it determined that the out-of-State activity was having a harmful effect on an in-State activity (retailing). Of course, that case involved a regulatory measure, not a tax measure, and New Jersey has advanced no regulatory objectives in these cases.

least where skewing of significant magnitude is obvious as soon as the deduction being disallowed is described, as it is when a non-producing State disallows a deduction for a substantial cost incurred only in oil production.[23] This requirement is consistent with the Commerce Clause's concern with protecting interstate commerce, not particular businesses (*Exxon Corp.* v. *Maryland*, 437 U.S. at 127-128), with this Court's frequent warnings that some imperfections must be tolerated, and with the Court's focus on practicalities in defining constitutional standards in this area (*e.g.*, *Container Corp.*, 463 U.S. at 185-193; *Moorman Mfg.*, 437 U.S. at 278-279). Practicalities would obviously be highly relevant in seeking to delimit whatever class of cases to which appellants' challenge may apply.

c. For the reasons we have explained, *if* windfall profit tax liability is a site-specific cost not comparable to an in-State cost, there is present in these cases a substantial, constitutionally problematic geographic skewing (the free-rider problem) of the New Jersey corporate income tax base.[24] The remaining questions are whether the windfall profit tax paid to the United

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[23] These cases do not present any but the starkest geographic skewing. New Jersey has no oil production. (Similarly, six of the other seven States that have denied a deduction for the windfall profit tax have either no oil production or a de minimis amount.) 87-453 J.S. 14-15. Appellants characterize the impact here as falling on a "discrete group of substantial taxpayers" (*id.* at 18), and they note that the impact is itself appreciable (*id.* at 13-14; see note 16, *supra*). They stress that New Jersey's tax is "*structurally* defective, so that it necessarily distorts the net income base of every integrated oil company" (87-453 Br. in Opp. 5 (emphasis added)).

[24] In addition to the fact that New Jersey has no oil production at all, the deduction denial effects an appreciable increase in New Jersey liability both in dollar amounts (see notes 16, 23, *supra*) and in percentages (see J.S. App. 84a (table)). We note that, because the tax liability is calculated by multiplying "entire net income" by the apportionment fraction by the tax rate, the same percentage increases in tax liability could have been achieved by leaving the "entire net income" base unchanged but increasing the apportionment fraction by the same percentages. For example, the deduction disallowance for Atlantic Richfield in 1981 caused a 174% increase in tax liability (*ibid.*); this is the equivalent of a 174% increase in its apportionment fraction of 1.0995% (Pltf. Jt. App. 757a, 783a) to more than 3%. And for Gulf in 1981, to obtain the

States is a site-specific cost and, if so, whether its deduction may nonetheless be disallowed because it is sufficiently like another in-State outlay whose deduction is also disallowed by the State. The first question does not seem difficult: the windfall profit tax is site-specific in the critical respect – liability for it is as directly related to activity that takes place at a geographically identifiable place as is liability for an ordinary severance tax. The second question is more difficult, though it may be substantially narrowed. Because the only non-deductible outlay that is (or could be) alleged to be comparable is federal income tax liability,[25] this question calls for an inquiry into whether the windfall profit tax is more like an ordinary severance tax, whose subtraction New Jersey allows in calculating the "entire net income" tax base, than it is like the federal income tax, whose subtraction New Jersey does not allow.[26]

In examining that seemingly determinative question, it seems to us that full briefing and argument is needed. We have not ourselves come to a conclusion on the question. We note here simply that most of the relevant considerations seem to point toward appellants' resolution – that windfall profit taxes are a

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same increase in tax liability, the apportionment fraction would have to be increased more than 11-fold from 1.3564% (Pltf. Jt. App. 946a, 974a) to more than 16%.

[25] Of course, the reason deduction of the windfall profit tax is disallowed is that the New Jersey Supreme Court found it to be a tax, like the federal income tax, that is "measured by profits or income" (N.J. Stat. Ann. § 54:10A-4(k)(2)(C) (West 1986)). The court did not justify the State's treatment of the windfall profit tax based on any assertedly offsetting unrelated special advantages afforded oil producers by federal or state tax laws. On the subject of offsetting-benefit justifications, see, *e.g.*, *American Trucking Ass'ns*, slip op. 20-21; *Tyler Pipe*, slip op. 14-15; *Travis* v. *Yale & Towne Mfg.*, 252 U.S. at 81.

[26] New Jersey denies all taxpayers a deduction for federal income taxes, and that plainly has no overall disparate geographic effect. By contrast, New Jersey ordinarily allows subtraction of severance taxes, because such taxes would be deductible business expenses or costs of goods sold in calculating the federal taxable income on which New Jersey bases its tax. See 26 C.F.R. 1.164-3(f); 2 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 32.2.3, at 32-17 to 32-18 (1981).

site-specific cost like ordinary severance taxes and unlike federal income taxes. But cf. *Tenneco West, Inc.* v. *Marathon Oil Co.*, 756 F.2d 769 (9th Cir.), cert. denied, 474 U.S. 845 (1985) (contract interpretation).

We begin with the formal operation of the tax measures to be compared. The federal corporate income tax, like the personal income tax, is imposed on persons for their overall annual activities. By contrast, the incidence of the windfall profit tax is on a specified activity or transaction, which takes place at a particular time and at a particular place: a tax is owed "upon the removal of taxable crude oil" (H.R. Conf. Rep. 96-817, 96th Cong., 2d Sess. 106 (1980)). Moreover, whereas the measure of the federal income tax is based on the taxpayer's company-wide and overall bottom line, the measure of the windfall profit tax is a figure tied to the particular producing property (in a particular State) at the time of removal. Hence, there is a direct relation between the oil production activity at that time and place and windfall profit tax liability, as with an ordinary severance tax; and losses from other properties or other business activities are not offset, as they are for the income tax.

Further, even with the per-barrel "net income" limitation, the measure of the windfall profit tax generally depends on value at the property and not, like the income tax, on actual revenues: for oil transferred within an integrated company, the "uncontrolled" price used to calculate the tax base is the "posted" price at the producing property at the time of removal (see I.R.C. §§ 613, 4986, 4988; 26 C.F.R. 1.613-3(a)).[27] And that is so, apparently, without regard to whether the particular oil ends up producing less revenue because of future events such as casualty losses or a decline in prices between removal and sale at the pump.[28] Thus, the New Jersey Supreme Court, citing evidence

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[27] The applicable regulation states, in pertinent part: "[T]he gross income from the property shall be assumed to be equivalent to the representative market or field price of the oil or gas before conversion or transportation." 25 Fed. Reg. 11804 (1960); see 26 C.F.R. 1.613-3(a).

[28] There are two ways in which a producer can earn less net income from a barrel than the general "windfall profit" – *i.e.*, "removal price" minus "adjusted base price." One is for the producer to earn less revenue than the ex-

submitted by the State, stated (J.S. App. 29a) that "[t]he posted price fixes the value of the oil at the point of lifting. Later events do not detract from this fact." See also Pltf. Jt. App. 1142a (stipulation) (appellants did not receive windfall profit tax refunds or credits for oil lost after removal). The federal income tax, of course, depends on actual revenues and on activities throughout a company throughout the year.

Congress's understanding generally supports the conclusion that the windfall profit tax is closer to an ordinary severance tax than to the income tax.[29] First, although statutory labels are not conclusive (*Complete Auto*, 430 U.S. at 279, 281), the windfall profit tax was proposed, enacted, and understood by Congress as an "excise" or "severance" tax. See I.R.C. § 4986; 15 Weekly Comp. Pres. Doc. at 723; H.R. Conf. Rep. 96-817, *supra*, at 92; H.R. Rep. 96-304, *supra*, at 2; S. Rep. 96-394, *supra*, at 2, 29, 154. Consistent with that understanding, Congress, in estimating the expected revenues from the windfall profit tax, expressly assumed that the tax would be deductible for state income tax purposes. H.R. Conf. Rep. 96-817, *supra*, at 163; H.R. Rep. 96-304, *supra*, at 9; S. Rep. 96-394, *supra*, at 9. Further, Congress had imposed excess profits taxes during World

pected revenue that was assumed when the posted field price at removal was set—because, for example, of losses or price drops. The other is for the producer to incur higher costs than the "adjusted base price" reflects. Congress mentioned only the latter problem in explaining the "net income limitation." S. Rep. 96-394, *supra*, at 29; H.R. Rep. 96-304, *supra*, at 2.

Indeed, Congress not only did not provide for adjustments in the event of post-removal changes in revenue, but it adopted the excise tax mechanism, for enforcement-simplification purposes, specifically to eliminate the need to look past the single event of removal. H.R. Rep. 96-304, *supra*, at 43; S. Rep. 96-394, *supra*, at 66. Both congressional committees stated, "only one event determines the windfall profit tax liability—the first sale" (which is deemed to be removal, where no on-site sale occurs). H.R. Rep. 96-304, *supra*, at 43; S. Rep. 96-394, *supra*, at 66. Congress also gave the Secretary of the Treasury the authority to ensure that, notwithstanding the sale price, "parties use a removal price which clearly reflects the fair market value of the oil" (S. Rep. 96-394, *supra*, at 67). See H.R. Conf. Rep. 96-817, *supra*, at 105.

[29] Even if the evidence of Congress's understanding is not sufficient for a preemption argument, it is relevant to determining the character of the windfall profit tax.

War II and the Korean War; and those taxes, like the income tax itself, were imposed on company-wide bottom-line income.[30] Yet the 1980 Congress that enacted the windfall profit tax, while specifically noting those precedents, departed from them for the "far simpler approach" of "an excise tax" (H.R. Rep. 96-304, *supra*, at 7). Thus, although Congress's motivation was to tax what it determined to be expected windfall profits, the evidence shows that it chose to accomplish that end by what it understood to be a transaction- or activity-based tax akin to a severance tax.

Against these considerations, the principal argument in favor of finding similarity to the income tax is the argument implicit in the New Jersey Supreme Court's view, expressed in construing the add-back provision (J.S. App. 16a-29a), that the windfall profit tax is imposed on some portion of revenues that is net of real economic costs.[31] In this view, New Jersey is simply ignoring the federal government's two-part separation of what is all real net income of oil producers. If the federal government or any State imposed any other taxes that worked in the same way, the argument would run, New Jersey would treat them in the same fashion; and in any event, New Jersey has broad freedom to determine for itself that this reasonable way is the proper way of viewing the windfall profit tax.

It may be that this argument, in light of the leeway permitted States under the Constitution, should lead ultimately to rejection of appellants' contention. We note, however, that there are

[30] Excess Profits Tax Act of 1950, ch. 1199, 64 Stat. 1137; Revenue Act of 1942, ch. 619, §§ 201-230, 56 Stat. 899-936; Second Revenue Act of 1940, ch. 757, § 201, 54 Stat. 975-998; see H.R. Conf. Rep. 3002, 76th Cong., 3d Sess. 42-48 (1940); H.R. Rep. 2333, 77th Cong., 2d Sess. 18-19 (1942); H.R. Rep. 3142, 81st Cong., 2d Sess. 1-4 (1950); see also Revenue Act of 1917, ch. 159, 39 Stat. 1000.

[31] It does not advance the inquiry to suggest that New Jersey is simply taxing the full amount it would have taxed if the United States had not imposed a windfall profit tax, and instead taxed profits only through the corporate income tax, or that New Jersey is simply taxing in one stage what the federal government taxes in two. The same suggestions could be made for any new federal severance tax; and the first suggestion could be made for any new "real" cost of business.

difficulties with this argument. First, there are practical and theoretical problems with trying to determine which of the various amounts a company must pay out to others (including governments) constitutes a "real" economic cost. Second, even if the proposed distinction between costs of earning income and payments out of income earned were sound, the windfall profit tax would appear to fall into the former category. As we have noted, and as the New Jersey court itself pointed out based on submissions by appellee (J.S. App. 29a), the windfall profit tax is incurred (and, as far as the statute and regulations suggest, measured) without regard to the eventual receipt of income for particular oil after its refining and marketing. Third, it is not clear that the argument, even if it were workable and it applied here, would be a sufficient answer to the considerations adduced above, because a tax that is imposed even on only a portion of the value of a site-specific activity remains, like an ordinary severance tax, directly related to the level of activity at that site, and not to company-wide activities. Finally, the fact that all taxpayers are taxed only on "real" net income does not necessarily cure all constitutionally problematic geographic skewing: such skewing would be present, for example, if New Jersey allowed a deduction for one-half of "real" net income to all taxpayers except those who engage in oil production.

In sum, appellants have a substantial argument that the windfall profit tax is a site-specific cost of business comparable to an ordinary severance tax. Because New Jersey excludes other severance taxes from its corporate income tax base, and because the windfall profit tax is incurred only for out-of-State activities, appellants have a substantial constitutional claim.

CONCLUSION

For the foregoing reasons, probable jurisdiction should be noted.

Respectfully submitted.

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